Déjà Vu All Over Again: What Are The Chances That The United States Follows Japan's Decade-Long Funk?

Little more than a decade ago, Japan, like the United States today, was on top of the world. Tokyo officials prided themselves on Japan's high productivity growth and booming financial markets, which led to a sense of cultural superiority. The world was scrambling to figure out how to adapt to the Japanese model. Meanwhile, Japan's political system was weak with little real division between parties, which were dominated financially by a vast array of special interests. In this highly leveraged economy, most felt the positive situation would last forever. Does the United States today risk being similarly overconfident?

Those (problems) that worry me the most are the melancholy combination of our negative personal savings rate and gargantuan, unprecedented current account deficits.

PETER PETERSON
Chairman, The Blackstone Group, L.P.

Japan's vaunted savings rate did not translate efficiently into productivity enhancing investments. Why? For one thing, deregulation in Japan and reform of its extraordinary special interest political system moved at less than a snail's pace, leaving such vital sectors of the economy as food, transportation, distribution, retailing, energy, and, of course, banking at a significant competitive disadvantage. Meanwhile, at the same time that America's labor-mobile economy was undertaking major restructuring and downsizing in its Old Economy, lifetime employment was leaving much of the Japanese economy stuck in the past.

On these, and most systemic issues, I believe America has a relative edge.

Let's start with demography, a subject I have written about extensively. America's birth rate is at the highest levels of the industrial country world. Even with its relatively high rates of fertility and immigration, growth in the U.S. labor force is projected to come to a virtual standstill within a decade or two. Labor force growth, along with productivity growth, is, of course, a crucial factor in determining GDP growth. Japan, which did not experience a baby boom, projects a decline of 25 percent in the number of workers under the age of thirty by 2010. And most of Europe—with Italy leading the way—has birth rates far below the so-called replacement rate that keeps the population stationary.

Next, technology in general, and information technology in particular, are other areas where America also excels. The Federal Reserve Bank of New York has just completed an impressive study on the critical role of our vast investment in information technology (some $400 billion last year) in energizing the productivity boom in the United States. Also, no country matches the U.S. venture capital market, either in size or fluidity.

Finally, America stands alone at the top of developed nations in terms of deregulation, labor mobility, and openness of our markets to other world-class products that provide a decisive competitive stimulus.

We have good reasons to believe these systemic forces will continue to be decisive in this revolutionary, competitive world we are living in. Obviously, not all the systemic forces are in America's favor. Those that worry me the most are the melancholy combination of our negative personal savings rate and gargantuan, unprecedented current account deficits. Given the experience of the latter half of the 1980's, when projected account deficits were at much lower levels, we know what happened to the dollar, markets, and short and mid-term economic forecasts. Thus, in spite of the conventional odds that favor the soft landing, I think the odds of a hard landing are not insignificant.

So, put me down as feeling the odds are about 20 percent that the United States may also stumble in the next decade.

Japan was predestined to stumble. The United States is not predestined, but if it does stumble, it will have company elsewhere in the world.

GARY HUFBAUER
Senior Fellow, Institute for International Economics.

Nothing would delight the doomsday crowd more than to see the United States imitate the pratfalls of Japan. Indeed, the celebration might have global overtones. Many countries share the French view that American "hyperpower" is too arrogant and too self-satisfied—in economic as well as military matters.

But there are important differences between Japan in the early 1990's, and the United States today. The differences add up to two propositions: Japan was predestined to stumble, and could stumble alone. The United States is not predestined, but if it does stumble, it will have company elsewhere in the world.

In the early 1990's, *everything* in Japan was overvalued, *except* the exchange rate. Real estate was priced to the moon. The grounds of the Imperial Palace alone were said to be worth more than all the real estate in California. The *entire* Japanese stock market was priced at more than seventy times earnings. The financial system ensured that bank credit was directed to crony firms, who made bad investments on a grand scale. Meanwhile, the Japanese authorities ran a persistent current account *surplus* in the vicinity of $80 billion, and an undervalued exchange rate in the vicinity of 140 yen to the dollar. With this combination, it's no surprise that the stock and real estate markets collapsed, that corporate waste reached magnificent levels, and that internal troubles were magnified by yen appreciation during most of the 1990's. The Japanese external sector could not and did not absorb much of the internal trauma.

Comparable speculative excesses in the United States are confined to the NASDAQ. Old Economy stocks may be high, but they are not in the stratosphere. Real estate is frisky but not frothy. The U.S. financial system is pretty effective at channeling credit and firing bad managers. Moreover, the U.S. external sector could become a shock absorber.

The mighty NASDAQ reached an earnings multiple of 160 in March 2000, creating paper wealth of about $6.6 trillion for all NASDAQ issues. By comparison, the S&P 500 index barely exceeded thirty times earnings, representing paper wealth of about $15.4 trillion for all issues listed on the New York Stock Exchange (NYSE).

Since March, a 40 percent drop has wiped out $2.6 trillion of NASDAQ wealth. A 13 percent drop in the S&P 500 has eliminated another $2.0 trillion of NYSE wealth. The carnage is not over—especially not in the NASDAQ. If the NASDAQ drops to 1500—bringing it to fifty times earnings—another $2.0 trillion will vanish. Toss in a further 10 percent drop in the S&P 500 (bringing its earnings multiple to the low twenties), and another $1.3 trillion of paper wealth goes out the window. How bad would that be? Well, no one feels good about losing $8 trillion. But capital losses, even on that scale, don't mean the economy needs to stagnate for a decade. Productivity growth is still on track and companies are relentlessly driven both by global product competition and hostile takeovers. Those forces didn't exist in Japan.

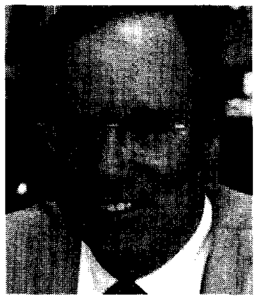
A drastic drop in paper wealth should prompt American households to rediscover the virtue of saving 5 percent of their income—not a bad idea. This prospect brings us to the international side of the equation, the value of the dollar and the size of the current account deficit, now around $400 billion. The dollar has a real trade-weighted value some 30 percent above its level five years ago. The current account deficit and the exchange rate can be great shock absorbers. If a fall in U.S. stock market wealth is accommodated by greater household savings, a lower value of the dollar, a smaller current account deficit, *and* faster economic growth in Europe, Japan, and the emerging markets, fine. Faster growth abroad is critical. If all the pieces don't fall into place, we'll have a very hard landing, and not only in the United States.

I do not see the same exuberance in the United States, even if some stocks may still be overvalued.

HORST SIEBERT

President, Kiel Institute of World Economics, and member, German Council of Economic Advisers.

No, the United States will not follow the footsteps of Japan. First, Japan experienced a huge financial bubble in 1990 that came about because of the excessive increase in the money supply that, though not translating into an increase in consumer prices, did fire up stock and land prices. I do not see the same exuberance in the United States, even if some stocks may still be overvalued. Moreover, a correction has already occurred in the stock market. Second, there was not such an excessive increase in the money supply as in Japan. Third, and a little ironically, the United States was also not pressured by famous economists to play the demand locomotive for the world economy, as Japan was (see my article, "Japan's Policy Trap: A European View," in the January/February 2000 issue of *The International Economy*). Fourth, there is a New Economy in the United States with an increase in labor productivity and quite a bit of flexibility. Fifth, the United States is a more competitive economy, being able to adjust more flexibly to exogenous shocks. Markets are more important than the Japanese structured and planned approach. Sixth, I expect the country to rally behind the new president now that the election deadlock has been resolved.



The most dramatic contrast with America's current economic performance is not Japan a decade ago, but America itself during its last comparable boom in the 1960's.

C. FRED BERGSTEN

Director, Institute for International Economics.

There is very little risk that the United States will become overconfident and suffer a severe economic reversal as Japan did a decade ago. The chief reason is the dramatic increase in the globalization of the American economy, which forces American industry to continually improve its productivity performance by taking full advantage of the information technology revolution. By contrast, Japan's openness to external forces has actually declined over this period and hence reduced the imperative to modernize for much of Japanese industry.

In 1960, exports plus imports of goods and services accounted for about 8 percent of the American economy. Today that number approximates 30 percent (and the real impact of globalization pressures across the economy is far more pervasive, as revealed by the adjustment anxieties that they cause in "non-tradeable" sectors as well). Such an increase in economic openness for a mature industrial economy is historically unprecedented. The resultant competitive pressure on American industry is inexorable and, interacting intimately with the IT revolution, largely explains the sharp and accelerating growth in productivity that has produced the economic renaissance of the United States.

The most dramatic contrast with America's current economic performance is not Japan a decade ago, but America itself during its last comparable boom in the 1960's. American industry did become complacent toward the end of that period, sowing the seeds of the country's economic troubles over the succeeding decade or two, largely because it failed to recognize the onset of tough competition from around the world. There is no evidence of any such complacency at present.

Part of the competitive pressure from globalization of course manifests itself through the capital markets, where the United States is under intense pressure because it must attract net capital inflows of well over one billion dollars per day to finance the current account deficit. The constricted structure of Japan's capital markets, and particularly the excessive dependence of its banks on the performance of the Japanese stock and real estate markets, were, by contrast, among the most important causes of the collapse of its "bubble economy" in the early 1990's.

Trend growth in the United States should be about twice as fast as in Japan for the foreseeable future. Labor productivity growth here has reached at least 3 percent per year and continues to accelerate while Japan will do well to restore its productivity expansion to 2 percent annually any time soon. The U.S. labor force will grow about one percent per year while Japan's is stagnant.

The United States continues to face serious economic problems: weak K-12 education, low savings and the huge external deficit, worsened income distribution and stagnant incomes for large components of the population. But we can confidently expect U.S. economic growth to average about 4 percent for at least the next few years, compared with about 2 percent in Japan, continuing the dramatic reversal in the economic fortunes of the two countries that was ushered in during the 1990's.

The final difference relates to economic policy. If American growth falters, the Federal Reserve can readily reduce interest rates from their high real level—as it did in late 1998 to prevent the global credit crunch that was rightly feared in the wake of Russian default, Brazilian devaluation threat, and failure of LTCM. In addition, the large budget surplus permits the President and Congress to cut taxes speedily to provide any required fiscal boost. The United States will certainly not raise taxes in the face of a recession and run a tight monetary policy in the face of deflation, as Japan has done. Much of Japan's malaise has been self-inflicted and it seems highly improbable that the United States would make the same mistakes.

Today the question is whether the "New Economy" in America is a kind of re-run of the Japanese manufacturing "miracle."

ULRICH RAMM
Executive Vice President, Commerzbank AG.

Maybe 10 percent—history does not repeat itself, not even as farce.

Back in the 1980's, the Japanese indeed revolutionized manufacturing, and companies—buoyed by their own success—over-invested heavily, laying the groundwork for today's capacity glut. Recall that by the end of the decade, Japanese firms had so much trouble finding promising investment projects, they went on a buying spree, snapping up Hawaiian golf courses, New York landmark buildings, and Van Gogh paintings for their office walls. In the end, even the economic boom did not justify stratospheric equity and property valuations, and the bubble burst. Economic policy then failed in the challenge of dealing with the crisis, exacerbating and prolonging the problems. Unfortunately, recent events show how strong the inertia inherent in the political system remains.

Today the question is whether the "New Economy" in America is a kind of re-run of the Japanese manufacturing "miracle." While Japan exported capital, the United States attracts investment from the rest of the world—the corollary of its $400 billion current account deficit—that has helped finance an unprecedented spurt in consumption demand and in high tech spending. Is this simply another bout of over-investment? It depends on where you stand in the "New Economy" debate. As an avid New Paradigmer, you would argue that the productivity enhancing character of IT-spending justifies current investment and stock valuation levels. A die-hard tech skeptic would naturally argue that it will all end in tears, pointing not just to parallels with the Japanese experience but also with the 1929 crash.

A realist would say: Economic conditions in the United States will—and incidentally have started to—return to a more sustainable path, very likely in an orderly manner. U.S. policymakers have been aware for some time now of the challenges posed by the productivity surge. It will be far from easy to effect the transition, especially ending the dollar misalignment without inducing a market crash. However, I have confidence in the Fed's ability to handle the situation and to deal successfully with any price-bubble that might occur.

Japan has been suffering from stagnation. The U.S. experience has been characterized by sharper recessions from which the economy has bounced back quickly.

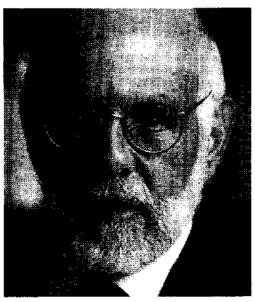
SAMUEL BRITTAN
Principal Economic Commentator,* Financial Times, *London.

I would put the chances of the United States following in Japan's footsteps at about 20 percent. This judgment is not worth very much, as it is so heavily dependent on the degree of similarity required.

My answer does not in the least suppose that the United States has discovered the economic philosopher's stone—that is the way to eliminate the business cycle. But Japan has not been suffering from an American-style recession. Contrary to popular belief, there has been only one out of the last twenty years in which the Japanese GNP has fallen from one year to the next. What Japan has been suffering from in the 1990's is stagnation, with output growing very little or at all. The U.S. experience has been characterized by sharper recessions from which the economy has bounced back quickly.

There are many vulnerable features about the U.S. situation: a high current payments deficit; a large private sector deficit; an overvalued stock market and dollar; and arguably an economy operating above the limits of safe capacity working. My main reason for believing that, whether there is a soft landing or a hard one, the United States will not experience a decade of stagnation is political.

With underlying productivity rising, stagnation means ever-growing unemployment. This is something that the United States will not tolerate after its experience of the 1930's. In the last resort, monetary and fiscal orthodoxy would be abandoned to the extent necessary to stimulate demand. And in contrast to Japan (where the United States has been opposed to a low yen), there would be no Big Brother standing in the way of the necessary currency depreciation.



Even if we experience a harder landing, it is improbable that any recessionary period will be as intractable as that which Japan continues to experience.

FRANK PEARL

Chairman & CEO, Perseus, and Founder & Chairman, Rappahanock Investment Company.

The notion that the profile of the Japanese economy in the 1980's is prophetic of the future of the U.S. economy is seductive but only superficially so. I would suggest that one consider the following significant features of the Japanese economy that led it to its current moribund state in contrast to the present dynamics of the U.S. economy.

First, there are fundamental structural differences between the Japanese economy and that of the United States. In the 1980's, Japan was not a developer of technology, but rather a brilliant manufacturer and, indeed, it seems, a flash in the pan. Most of the technology that created the huge Japanese trading empires was developed elsewhere. As the United States economy has rid itself of the unproductive structural clutter, which had allowed the Japanese to exploit U.S. technology, real technology inspired growth has shifted from Japan to the United States. Japan's difficulty with innovation is magnified by cultural norms that do not celebrate entrepreneurial energy.

Second, the Japanese inability to create profound technological advances is in large part a result of an archaic series of structures that govern all aspects of the Japanese economy. In fact, Japan is a very inefficient place with huge bureaucratic obstacles to change, enormous costs imbedded in its distribution systems, almost insurmountable barriers to innovation, and a lack of mobility in the work force.

Third, the demographics of Japan are a nightmare for growth. An aging, insecure population is saving rather than consuming. This phenomenon is compounded by the consistent inability of the Japanese government and its central bankers to understand that the key to perpetuating growth is maintaining an appropriate balance between consumer demand and investment, a tricky tight rope that Mr. Greenspan and his colleagues have skillfully walked. The Bank of Japan has now apparently fallen into the Hooverian trap of believing the Calvinist idea that the answer is an economic contraction that causes pain to force structural change.

Fourth, the investment side of the equation is particularly problematic for Japan because Japan is a difficult country in which to invest due to the rigid interlocking arrangements among the major participants in its economy and because of the lack of opportunity due to domestic demand limitations caused by Japan's almost unique demographics. Further, regulatory "rigging" of the banks' balance sheets and other financial institutions has been a part of Japanese economic life for decades. Thus, even today, distressed loan portfolios are carried at artificially high values, a practice that has a smothering effect on financial institutions and entrepreneurs.

While these differences with the U.S. economy are profound, I would suggest that we should not feel complacent here as we do share certain traps that are similar to the Japanese economy of the 1980's, such as unsupportable valuations in our markets which, when they are correct, will likely leave investors shaken for a meaningful period of time.

Further, the jury is still out as to whether the productivity gains of the last several years are sustainable. Consumer confidence, a commodity currently in short supply in Japan, is now rather fragile in the United States as well, and if we experience waves of bankruptcies of Internet, ecommerce companies, and the like, as I believe probable, confidence may be sufficiently shaken to slow our economy rather more and longer than circumstances might otherwise dictate. High oil prices, while perhaps temporary, also historically have an adverse affect on consumer confidence and there is now evidence of a significant credit contraction, interestingly caused not by the Fed desiring to restrict money supply but apparently by the Office of the Comptroller of the Currency anticipating the weakening of bank balance sheets due, in considerable part, to the high rise telecom sector lending of the last few years.

Perhaps the Fed can engineer a soft landing, but the depressants described above, along with a confused political situation, will certainly require an exquisitely delicate touch. Ultimately, however, even if we experience a rather harder landing than our unparalleled decade of prosperity has led us to expect, for structural and demographic reasons it is improbable that any recessionary period in the United States will be as deep, lengthy, or intractable as that which Japan continues to experience.

The continuing positive evolution of the United States' economy is highly probable.

LORD BRITTAN OF SPENNITHORNE

Former member, Lady Thatcher's Cabinet, and former Vice President, European Commission.

I do not think that the situation of the United States is in any way comparable to that of Japan a decade or so ago. High productivity growth, largely derived from the rapid and adept use of new technology, shows no sign of coming to an early end. The continuing positive evolution of the United States' economy is therefore highly probable.

This does not mean that growth is likely to continue at as fast a rate as it has done in recent years. It certainly does not mean that there are no risks and problems facing United States. It is perfectly possible that those risks and problems will lead to significantly inferior economic performance than has been enjoyed recently, but I think it most unlikely that they will lead to the kind of stagnation that has characterized Japan in the past decade.

The first risk is that the policies advocated by both the recent presidential candidates are actually implemented. This would lead to lower taxation combined with higher spending, and that would be an extremely inappropriate prescription for the U.S. economy.

Related to this is the risk that there is in any event as a result of the present very high current account and trade deficits. Most economists consider that these are not sustainable in the long term, and that a correction is likely to be brought about by or accompanied by a substantial fall in the current value of the dollar. This would have mixed and complex effects, but it is certainly possible that this would lead to a substantial reduction in the rate of growth of the U.S. economy.

Finally, account has to be taken of what is happening in Europe. I believe that the rapid restructuring of the European economy that is going on as a result of the introduction of the euro is likely to lead over a period of time to Europe being in a much stronger competitive position than it has been in recent years. As I do not believe in international economics being a zero sum gain, this does not necessarily imply that the United States will become weaker in absolute terms. But it does mean that the United States' comparative position is likely to be less strong.

A U.S. recovery would come earlier and be faster than the lethargic affair now under way in Japan.

RUDOLPH G. PENNER

***Senior Fellow, Urban Institute, and Co-Author with Isabel Sawhill and Timothy Taylor,* Updating America's Social Contract.**

There is essentially no chance that the United States will follow in Japan's footsteps. That is quite different from promising that the United States will avoid a hard landing.

A severe U.S. recession is much more probable than indicated by the bulk of today's economic commentary. It is highly unlikely, however, that any U.S. recession will be followed by years of economic stagnation. For three reasons, a U.S. recovery would come earlier and be faster than the lethargic affair now under way in Japan. First, our political decision making processes are much more efficient. Reaching a consensus in the United States is not as complex and arduous, and though our Congress will be evenly balanced ideologically and gridlocked on many issues, it always responds well to emergencies. Second, our private sector is much more dynamic and flexible. Although there has been some economic restructuring in Japan, the government too often supports insolvent companies rather than letting them admit bankruptcy. Third, with a large budget surplus and an unusually low debt-GDP ratio, our initial fiscal position is far better, so we have much latitude to stimulate the economy with tax cuts. Japan is now extremely constrained by a debt-GDP ratio expected to exceed 130 percent this year and by worries over future fiscal demands from a population that is aging much more rapidly than ours.

The only possible constraint on U.S. fiscal policy comes from the fervent promise of politicians to put the Social Security trust fund surplus in a "lock box," which implies balancing the budget outside of Social Security. This obsession could result in a recession-enhancing policy response. More likely, however, a recession would put the goal of a balanced, non-Social Security budget so far out of reach that politicians' promises would be quickly forgotten.

Will the rapid U.S. growth of the boom years turn out to have been less New Economy and more illusion, like Japan's bubble economy of the 1980's? Probability: 10 percent.

JEFFREY A. FRANKEL

Harpel Professor, Harvard University, and former member, President Clinton's Council of Economic Advisers.

The conventional wisdom of 1990—that the Japanese model "could do no wrong"—resulted from Japan's strong economic performance in the 1980's. Similarly, the conventional wisdom of the year 2000—that the U.S. model can do no wrong—was based on America's strong economic performance in the 1990's. This view, too, may somehow fall by the wayside over the coming decade, especially if the macro policies of the last eight years are abandoned. The question is how.

Will the heights achieved by the NASDAQ at the turn of the millennium come to look foolish, with stock prices declining in the coming decade, as did Japanese asset prices in the early 1990's? Probability: 90 percent.

Will the U.S. real economy slow down from the rapid growth rate of the Clinton years, as did Japan's in the 1990's? Probability: 80 percent.

Will Republicans try to apply pro-cyclical fiscal policy, keeping taxes low when the economy is strong and raising them when the economy is weak, thereby exacerbating the business cycle—as did both the government of Japan and President George Bush, Sr.? Probability: 70 percent.

Will the dollar decline in the coming decade, as did the yen from 1995-98? Probability: 60 percent.

Will the tribulations of the 2000 presidential vote mark a turning point, after which the U.S. political system will no longer be taken globally as always the ideal model of democracy? Probability: 50 percent.

Will American credibility as a global leader be undermined by a lack of willingness to participate in and contribute to multilateral initiatives? Probability: 40 percent.

Will excessive indebtedness of the boom years contribute to a recession, as it did in Japan? Probability: 30 percent.

Will the American economic model become tainted by the failure of variants in crisis-prone emerging markets, as did the Japanese model in the Asian crises of 1997-98? Probability: 20 percent.

Will the rapid U.S. growth of the boom years turn out to have been less New Economy and more illusion, like Japan's bubble economy of the 1980's, e.g., attributable to unsustainably high levels of labor input (hours worked), requiring a corresponding period of below-trend growth to prevent inflation from accelerating? Probability: 10 percent.

Will American culture and the English language no longer dominate the world? Probability: 0 percent.

The United States will continue to be the only superpower. It will remain the youngest society among the G7, thus modernizing faster.

NORBERT WALTER

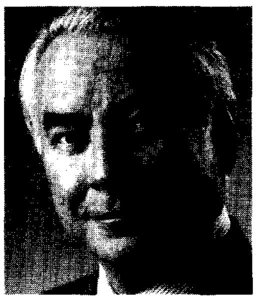
Managing Director, Deutsche Bank Research, and Chief Economist, Deutsche Bank Group.

Having been around in the analysts' circuit for about a quarter of a century, I have seen quite a number of cases of hype and their subsequent disappearance. To my mind there is not much that is as cyclical as (the perception of) structural problems.

However, this does not lead me to suggest that the "500-pound gorilla" of the 1990's in world politics, military, and business—the United States—will be down and out, and/or in danger of extinction by 2010. Yes, there *will* be considerably slower growth than in the second half of the 1990's. Yes, employment gains *will* be cut by half. Yes, the consumption bonanza, the rocketing investment *will* give way to moderation. By 2005, spending 102 percent of household income will be over, saving will be in fashion, and the current account deficit will have been halved. But the United States will continue to be the only superpower. It will remain the youngest society among the G7, thus supporting more creative destruction, thus modernizing faster than Europe—and much faster than Japan. It will do so because of higher birth rates and continued selective immigration. Its efficient financial markets will act as a catalyst in this process and as a magnet for international savings.

It is quite obvious, though, that the U.S. manufacturing sector has taken a severe beating and is in for a rough time, since the dollar has gone to crazy levels damaging companies' ability to compete on price everywhere, but especially versus Euroland suppliers. Thus a dearth of investment in manufacturing in the United States and a bonanza in Europe will be a reality in 2001-2002 and possibly longer. This will bring a rush of U.S. investment into Europe, followed later by similar moves from Asia (barring the re-emergence of a crisis in the Asian region).

Most of Japan's demise has to do with its aging, but part of it is due to the political crisis. So why such an unconditionally positive projection for the United States in 2010, after the demoralizing long counting of the ballots? Of course, my favored outcome of the U.S. election (to avoid international frictions)—Gore as president for the first two years, followed by two years of Bush to get the economy more market-oriented again—will not happen. But President Bush will not make a major difference for the fundamental outlook. And a change of majorities in Congress after 2002 will not change the basics either.



As long as America's economy remains open and flexible, there is less than a 10 percent chance that we will be afflicted with the Japanese disease.

RICHARD BURT
Chairman, IEP Advisors, Inc.

The geo-economic fate of nations does, indeed, at times follow a cyclical course, so there is a danger that America's current preeminence could fade. But this is highly unlikely. For a start, despite the beating the New Economy stocks have taken in the equity markets, we are continuing to live through a period of profound technological change, a revolution that favors those nations with open, agile, and responsive economies. And this is the secret of America's success during the last decade: the interplay of an innovative product market, a creative capital market, and a flexible labor market.

Needless to say, astute observers in Japan—and in Western Europe—have begun to recognize the reasons for U.S. economic success and have thus begun to take steps to emulate the American model. But in both Japan and Europe, structural rigidities and cultural predispositions limit how far they will be able to travel along the American path. For example, young Indian and Chinese computer and software specialists have served as foot soldiers in the American IT revolution. Japan and Germany, meanwhile, openly acknowledge that they are not "immigration countries." With the average age of both countries' populations becoming increasingly older, this will become an ever more important self-inflicted wound.

Of course, the U.S. economy is not immune to setbacks, and we, too, are capable of self-inflicted wounds. So at times it will appear that a changing of the guard is under way. But don't be fooled: As long as America's economy remains open and flexible, there is less than a 10 percent chance that we will be afflicted with the Japanese disease.

Americans are quicker than Japanese to recognize and acknowledge emerging problems.

RICHARD N. COOPER
Professor of International Economics, Harvard University.

Japan was on a high a decade ago. Japanese took their cue from many overseas observers. Ezra Vogel's *Japan is Number One* was a best seller. Some Americans extolled Japan's economic and financial performance, and a few even darkly foresaw a resurgent militarist Japan. The area of the Imperial Palace in mid-Tokyo, we were breathlessly told, was worth more than all of California. This was heady stuff. Yet price-earnings ratios on Japanese stock were over fifty, even as real rates of return were barely positive. Serious analysis suggested something was amiss.

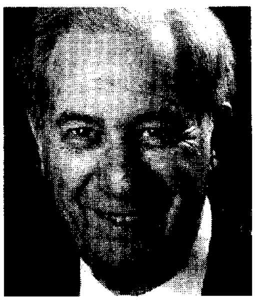
Not all observers were bedazzled. Karel van Wolferen grumbled that Japan was a country without direction, on mindless sales-seeking autopilot, capable of doing great damage both to itself and possibly to others.

Japan's economic performance was lackluster after 1990, but it was not terrible: Economic growth averaged about 2 percent a year, despite little population growth. The recession of 1998-99 was generated by a misguided fiscal contraction in 1997. A modest recovery is occurring, along with fundamental structural changes in attitudes and behavior that are difficult for any country.

Americans are certainly capable of overconfidence, and may be indulging in it now. It has an unpleasant tendency to become arrogance. Even admirers do not like to be reminded insensitively that theirs is an inferior economy or society, and are likely to respond by elevating local characteristics, even those of indifferent merit, into national virtues, in which the United States is seen to be deficient.

Could this overconfidence lead to an economic debacle? It is highly unlikely. The fundamentals of the American economy—its flexibility, and its capacity for innovation—are excellent, and were good even during the period of alleged "hollowing out" in the mid-1980's. The United States, like Japan, made a serious fiscal mistake, in the early 1980's, which took over a decade to correct. Americans have a remarkable capacity for self-criticism, which nearly matches their willingness to criticize others. Americans are thus quicker than Japanese to recognize and acknowledge emerging problems.

These observations should not be interpreted to mean no further decline in U.S. stock prices, or no depreciation of the dollar. Our journalists and politicians, and even some academics, will with certainty hype the significance and expound on the gravity of either development. But Americans should not be alarmed by such expostulations by these branches of our vigorous entertainment industry. They will be absorbed in stride by the American economy.



This nation is not destined to follow the boom-bust experience of its Asian trading partner.

MURRAY WEIDENBAUM

Visiting Scholar, Jones Graduate School of Management at Rice University (on leave from Washington University).

There is a strong temptation to draw a parallel between the prospects for the American economy in the years ahead and the experience of Japan. Like Japan in the 1980's, the United States rode high in the 1990's and was envied by the rest of the world. Although the record-long expansion in the United States seems finally to be running out of steam, this nation is not destined to follow the boom-bust experience of its Asian trading partner. Personally, I give the odds of that happening a modest one out of five.

First of all, the U.S. economy is far more open and hence much more flexible in adjusting to shocks and changes. We are much less bound by tradition and have made considerably more progress on economic deregulation. Our companies have more freedom to expand and contract their work forces, although downsizing is far from cost-free. Unlike Japan, no major sector is protected by government or tradition from facing economic reality.

Secondly, the pattern of the next few years may be more that of a rolling adjustment than a simple expansion-contraction cycle. The declines in civilian capital-intensive industries such as housing are likely to be offset, at least in part, by the start of a new capital-intensive weapon system replacement effort. (Much of the accumulation of Cold War equipment has been used up or rendered irrelevant to present-day security needs).

Of course, we should not underestimate the ability of the folks in Washington to mess things up. Nevertheless, we still have built-in stabilizers in the tax and entitlement systems that respond in a counter-cyclical fashion. Although helpful for long-term growth, a major tax cut would pick up new support if the threat of recession appears. And, surely, the Federal Reserve under Alan Greenspan's leadership has demonstrated the ability for timely yet limited intervention in financial markets.

How will we be able to tell if we are reliving the Japanese experience? Keep an eye on profits.

KEVIN HASSETT

Resident Scholar, American Enterprise Institute.

I believe that the chance is about 20 percent that the United States will follow in Japan's footsteps. For me the key factor is that U.S. firms and workers have evolved an ability to adapt their techniques and relationships in response to rapidly changing economic conditions. In the past, our economy grew because we made more Chevettes. Now growth often comes from the creation of entirely new products. While the future will undoubtedly surprise us all—with many firms that are blue chip today disappearing—American firms in the aggregate have the flexibility and ingenuity to flourish regardless of who wins and loses. While the Japanese economy has an enormous reservoir of human capital, its ossified economic institutions and relationships put it at a distinct disadvantage in the new economic environment. How will we be able to tell if we are reliving the Japanese experience? Keep an eye on profits. An early sign that sclerosis is beginning to affect the U.S. economy will likely be a steep and sustained drop-off in corporate profit growth.

The United States today is no more unstoppable than the Japan of a decade ago has proven to be.

CLYDE PRESTOWITZ
President, Economic Strategy Institute.

There are indeed many similarities between Japan of the 1980's and the United States of today. A decade ago, Japan was experiencing the same kind of rapid economic growth based on rising productivity and asset values that the United States has been enjoying for the past several years. Just as many then thought Japan had discovered a new key to success based on particular Japanese virtues, so today many see an apparently unstoppable American juggernaut founded on peculiarly American characteristics.

Without denying the pluses of either society, the fact is that both countries enjoyed extremely favorable circumstances during their booms while attributing success to their own virtues. During much of the 1980's, Japanese industry enjoyed the benefits of an undervalued yen, an artificially low cost of capital, and a relatively protected domestic market from which it could export freely to more open world markets. By the same token, over the past several years, the United States has benefited from extremely low commodity prices, economic turmoil in Asia and elsewhere, a heavy inward flow of capital, and a strong dollar.

Just as Japan's strong growth masked underlying weaknesses in the 1980's, so the United States today is not fully aware of the extent of its vulnerabilities, such as its extremely low savings rate and large current account deficit that makes it heavily dependent on capital inflow. The United States today is no more unstoppable than the Japan of a decade ago has proven to be.

Having said that, there is less than a 10 percent chance of the United States following in Japan's footsteps. For while a downturn of the U.S. economy is easy to imagine, the much greater transparency of the U.S. system coupled with a genuinely competitive political system is likely to result in much faster and more effective remedial steps in the United States than we have seen over the past ten years in Japan.

With the prospect of federal budget surpluses and some form of tax reduction, our economic future appears much more stable than that of Japan.

JERRY J. JASINOWSKI
President, National Association of Manufacturers.

While there are some similarities between the United States today and Japan roughly ten years ago, it's clear that the fundamentals of our economy are rooted in a much firmer bedrock than that of Japan's a decade back. First, the parallels: Between 1988 and 1991, Japan GDP growth averaged 4.9 percent while U.S. growth since 1997 has averaged close to 4.5 percent. In both cases, the economies were fueled largely by nonresidential fixed investment. In Japan, such investment combined with excess in real estate speculation and an asset bubble that was ripe for a fall. When joined with rising real interest rates, this scenario resulted in a major correction and a subsequent recession. Japan's domestic situation in 1990 was exacerbated by a global recession in 1991, which dried up Japan's export markets. This, combined with restrictive monetary/fiscal policy, helped create the poor economic situation that has existed in Japan since that time.

In recent months, the U.S. has expressed some of the same stock market extremes. In addition, like Japan in the early 1990's, we also have high real interest rates. However, unlike Japan in the early 1990's, our rapid pace of growth and productivity in recent years has been led by business-sector investments in equipment, especially computers that increase worker productivity and potential output.

In addition, the U.S. is not nearly as dependent as Japan on exports as a source for economic growth. In many sectors, our economy is self-sustaining. For example, during the 1997 Asian financial crisis, American economic output accelerated, while Japan's economic recovery was abruptly halted.

Finally, U.S. monetary policy has shown a great deal of flexibility in recent years. During the Asian crisis, the Fed reduced interest rates to provide some insurance for domestic growth. (Recent rate hikes have been in response to fears that the economy is outpacing potential output.) Japanese monetary policy did not appear to be as nimble as that enacted by the Federal Reserve.

With the prospect of federal budget surpluses that enable us to pay down—and eventually eliminate—the national debt and some form of tax reduction, which will foster growth, our economic future appears much more stable than that of Japan under similar circumstances.

Any correction of the excesses in the United States will be extremely painful in the short term but is likely to be resolved very quickly.

TADASHI NAKAMAE
President, Nakamae International Economic Research.

There are many similarities between the United States today and Japan a decade ago. Both economies suffered from excesses: over-investment, over-consumption, and an asset bubble. Moreover, indications that these excesses were out of control were ignored, perhaps due to the arrogance engendered by success. Regardless, the Japanese asset bubble collapsed, and it appears that the U.S. stock market is going the same way.

However, the situation in the United States today, and that of Japan in the early 1990's, are also different in one fundamental aspect: The United States is far more disciplined by market forces than Japan was then. As a result of this market discipline, any correction of the excesses in the United States will be extremely painful in the short term but is likely to be resolved very quickly. Perhaps even too quickly, in a couple of years rather than Japan's ten-plus, thereby laying the grounds for a second bubble.

In contrast, in the case of Japan a decade ago, the main economic actors were bureaucrats, bankers, and politicians. Market discipline did exist to some extent, but it was overshadowed by the traditional "powers." As a result, the economic leadership denied the existence of structural problems and attempted to reinforce the old economic order. As a result, ten years on, Japan still has to clean up much of the remaining financial mess. Unfortunately, over this period the Japanese economy has deteriorated to the point where a major financial crash has become inevitable.

A decade could make a huge difference. The fear in the early 1990's that Japan would overtake the United States has completely disappeared. Japan is now seen as a source of international economic instability rather than an economic powerhouse. Yet there has been a great deal of change: Market forces are now beginning to have a significant impact in Japan. Perhaps Japan might once again rise out of the ashes of disaster.

While our New Economy is not immune to recessions, we do not face the concatenation of deep structural problems that has stymied Japan's recovery.

MICHAEL H. ARMACOST
President, The Brookings Institution.

I think there is little likelihood that we will follow Japan's recent footsteps—maybe one in ten. To be sure, there are superficial similarities between the conditions we face now and those Japan confronted a decade ago. Like Japan, we have seen a strong wave of investment generate buoyant growth and dramatic productivity increases. The Fed, like the BOJ, has self-consciously engineered an economic slowdown. The NASDAQ has tanked, like the TSE in the early 1990's. American "triumphalism" bears some resemblance to the earlier hubris of Japanese bureaucrats and industrialists, and the Bible reminds us that "pride goeth before the fall."

But while our New Economy is not immune to recessions, we do not face the concatenation of deep structural problems that has stymied Japan's economic recovery for years. We are not plagued by the huge excesses of capacity, which afflict Japan's manufacturing industry, and impose such a drag on corporate investment. Our financial institutions are not burdened by the mountain of non-performing loans, which inhibit the capacity and willingness of Japanese banks to lend.

Inflexible labor markets do not pose the barriers to corporate restructuring in the United States as they have in Japan. America's greater openness to imports not only disciplines inflationary pressures, but provides continuous and relentless pressures on our companies to enhance productivity. Our consumer-oriented society provides a powerful and reliable source of domestic demand that has been missing in Japan. Our government is less resistant to reform and deregulation than Tokyo. And it currently possesses flexible monetary as well as fiscal tools to cope with a downturn.

That said, few experts predicted in 1990 that Japan would still be in the doldrums in 2000. No one anticipated the 1997 Asian financial crisis, and many appear surprised by the speed of Asia's current subsequent recovery. Indeed, only a few years ago it was conventional wisdom, even at Brookings, that the maximum sustainable, non-inflationary growth potential of the United States was about 2.5 percent. Hence, we should take nothing for granted. ◆